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# Silencing the Noise: Asbestos liabilities, accounting and strategic bankruptcy

## **Abstract**

The legacy of the global exploitation of asbestos provides an illustrative case to examine corporate strategy in response to the significant financial risk presented by the long-tail liability. The James Hardie group was the dominant asbestos manufacturing concern in Australia and, confronted with the uncertainties of burgeoning long-tail tort claims, embarked on a radical corporate reorganization. At the centre of the reorganization was the creation of a business unit of limited potential to separate asbestos long-tail liabilities from the profitable operations of the corporate group and locate the risk in an alternate legal arena. The strategic recognition of accounting assets and liabilities to construct a 'bottom line' and shift organizational boundaries is explored using Delaney's theory of strategic bankruptcy. This interdisciplinary and critical sociological lens highlights the power of organizations to exploit the malleability of accounting concepts to pursue their strategic goals.

## 1. INTRODUCTION

One of the hallmarks of the industrial exploitation of asbestos has been the complex corporate maneuvering to attenuate the financial liabilities that arise from compensation claims for asbestos-related disease. Two notable examples in advanced legal regimes, the Manville case in the US (Delaney, 1992) and Turner & Newall in the UK (McCulloch and Tweeddale, 2008; Tweeddale, 2000) have demonstrated the power of organizations to exploit their regulatory context to control litigation claims, potentially casting asbestos victims adrift. The purpose of this paper is to demonstrate how the management of James Hardie Industries Limited (James Hardie) engaged legal frameworks to avoid legal and moral obligations arising from asbestos operations in Australia. In a global environment, this paper contributes to our understanding of corporate reorganizations in jurisdictionally-bound legal regimes and highlights the tensions that exist between the desire for accounting to be standardized internationally and the malleability of accounting concepts in national contexts. This paradox is played out in practices such as transfer pricing, taxation and tax havens, general insolvency and also accounting for long-tail liabilities arising from exposure to toxic products.

Apart from tobacco, few mass-produced substances have proven as toxic to humans as asbestos. As a mineral renowned for its strength, flexibility and fire resistant qualities, it is still used extensively as an insulator and building material, despite a ban on its use or import in many countries (Moerman and van der Laan, 2013a). While the health risks associated with industrial and occupational exposure through the extraction, fabrication and use of asbestos have been documented and studied throughout the 20<sup>th</sup> century<sup>1</sup>, it was not until 1973 that a landmark US case highlighted the dangers to the general public from even trivial environmental exposure (Castleman, 1979). Previously confined to the domain of workers' compensation, this case expanded the reach of compensation claims for asbestos-related disease<sup>2</sup> into the arena of tort law. Given asbestos-related disease can manifest decades after exposure; this long latency period presents difficulties in ascertaining both the quantum and timing of tortious claims. Consequently, companies involved in the asbestos industry present a unique opportunity to examine strategic responses to the financial threat of long-tail tort liabilities<sup>3</sup> in the interstitial space where notions of stakeholder power, accounting representations, and the conceptual artifact of the corporate entity coalesce. This paper adopts a critical sociological approach from Delaney's theory of strategic bankruptcy to explore key aspects of the reorganization of the multinational and former Australian asbestos manufacturer, James Hardie.

While James Hardie currently produces a wide range of non-asbestos products globally, the story was quite different prior to the 1980s. As an Australian manufacturing conglomerate all James Hardie products contained asbestos and, as the Chairman, John Reid boasted in 1977;

every time you walk into an office building, a home, a factory; every time you put your foot on the brake, ride in a train, see a bulldozer at work...the chances are that a product from the James Hardie group of companies has a part in it (in Peacock, 2009, p. 137)

The ubiquitous use of James Hardie asbestos products resulted in a growing financial legacy from occupational and environmental exposure which continued to plague the corporate group. In an effort to "eliminate legacy issues that would otherwise continue to detract from value creation",

James Hardie embarked on ‘Project Green’ in 2001, a radical corporate restructure as a “comprehensive solution” (JHIL, 2001a, p. 1). This strategy involved creating a separate special purpose entity to fund current and future liabilities arising from asbestos litigation claims which threatened the availability of adequate funds to compensate a vulnerable group of stakeholders for asbestos-related disease. Burying ‘toxic’ balance sheet items in special purpose entities is not an unusual practice (see for example the high-profile cases of Enron in the US and Parmalat in Europe). However, this case differs in that, to enable the separation of the asbestos legacy from its core operating activities, James Hardie needed to make visible (albeit in a controlled manner) asbestos liabilities. In this case previously ‘known’ but incalculable future liabilities were rendered, seemingly overnight, calculable and consequently manageable. A strategic approach to bankruptcy, such as that offered by Delaney (1989, 1992), generates questions about management’s power to shift organizational boundaries, their ability to determine when long-tail asbestos contingencies become *official liabilities*; as well as the organizational power embedded in social relationships to enable the construction an organizational ‘bottom line’ (Eckstein and Delaney, 1993).

According to Delaney (1989, 1992), management facing uncertainty from long-tail tort litigation may pursue a strategy to move into a legal arena that provides greater certainty and affords more control. The arena of corporate law provides the framework to shift organizational boundaries and create a business unit of limited potential by exploiting the technical relationship between assets and liabilities (Delaney, 1989, 1994). However, corporate reorganizations are enacted in a unique historical, regulatory and socio-political context (Eckstein and Delaney, 1993) where options are limited and contingent upon the perceived relative power of adversaries to interfere in strategic actions (Delaney, 1994) – considered by James Hardie management as ‘stakeholder noise’. To explore the network of resources and constraints, we draw on prior research examining the James Hardie case. These accounts have considered: legal aspects (Dunn, 2005; Jackson, 2004; Prince et al 2004; Spender, 2003; 2005); societal and ethical implications (Gunz and van der Laan, 2011; Haigh, 2006; Peacock, 2009); management communications (Moerman and van der Laan, 2007; Moerman and van der Laan, 2011); and, the management of long-tail risk (Moerman and van der Laan, 2012). This paper differs from previous accounts by offering an approach that exposes accounting as a pivotal element in one of the most important events in Australian corporate history.

Organizational strategies explored from a critical sociological perspective challenge the presumption that accounting is a mere tool for economic decision-making providing the means to make economically rational decisions in an organizational context. Indeed, accounting has been portrayed as a tool of domination and oppression in a variety of contexts including slavery (see Fleischman and Tyson, 2004); the Holocaust (see Funnell, 1998); race and ethnicity (see Greer and Neu, 2009); and workers’ rights (see Tinker, 1985) among others. Adopting a similar stance, this paper demonstrates how accounting concepts can be used as a hegemonic resource to recognize liabilities and construct a ‘bottom line’, counterintuitive to mainstream assumptions of corporate management behavior (Delaney, 1989; 1992; 1994).

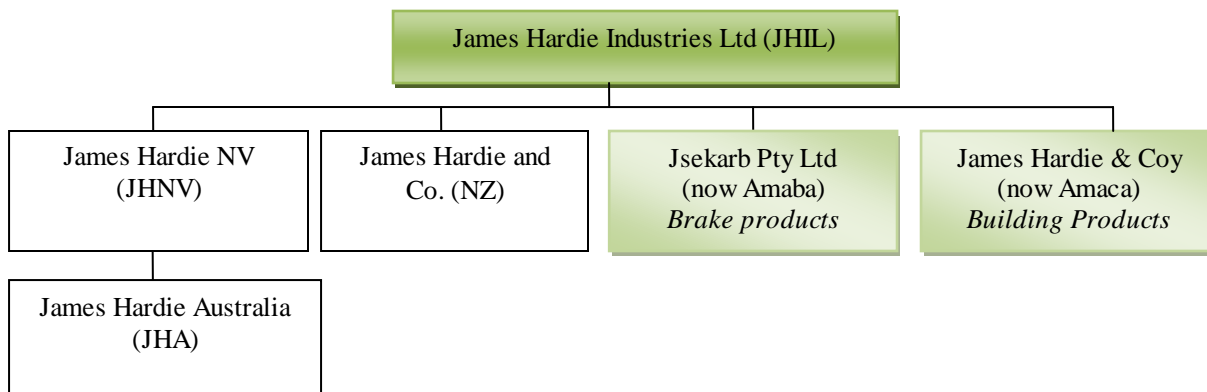
The paper begins with a description of the reorganization strategy of James Hardie. This is followed by a discussion of the challenges of interdisciplinary research and an outline of how the organizational goal of quarantining asbestos liabilities was facilitated through the strategic use of accounting concepts. A review of the institutions and networks considered to contribute to stakeholder noise leads to the conclusion that, despite jurisdictional nuances, James Hardie’s management were able to pursue a strategy consistent with strategic bankruptcy.

## 2. JAMES HARDIE AND ASBESTOS LIABILITIES

Asbestos has been mined since prehistoric times and anecdotal knowledge of the risks to health from asbestos exposure has been observed since the time of Ancient Greece (Castleman, 1979). Asbestos-related diseases<sup>4</sup> can be progressive and fatal and the cancer, mesothelioma, can manifest many decades after even tangential or incidental exposure. Therefore, claims for disease attributable to both occupational and environmental exposure are expected to continue well into the future as asbestos remains prevalent in the industrial and built environment and continues to be mined and manufactured in certain, particularly developing, countries (Virta, 2010). Asbestos remains a global issue and cases such as: Turner & Newall in the UK; Manville in the US; Cape Asbestos in South Africa; and, Eternit in Europe continue to present challenges for legislators, corporations and society.

In Australia the use of asbestos was widespread, particularly in the mid-1950s and through to the 1960s in a booming post-war housing market looking for a durable, heat resistant and easily transportable building product (Haigh, 2006). During this period 52% of the homes in the state of New South Wales (NSW)<sup>5</sup> were constructed using asbestos-fibre cement or ‘fibro’ (Safe Work Australia, 2009). In Australia, mesothelioma is a notifiable disease (since 1982) and the number of new cases diagnosed has risen dramatically (Safe Work Australia, 2009). Despite the ban on the use and import of asbestos in 2003, a ‘new generation’ of litigants is emerging from the incidental exposure to asbestos during the renovation of homes and buildings and environmental asbestos remediation (DEEWR, 2012). Asbestos products were manufactured by subsidiaries of the parent company, James Hardie Industries Limited (JHIL). In particular, James Hardie and Coy (Coy<sup>6</sup>) produced building and construction products and Jsekarb Pty Ltd (Jsekarb<sup>7</sup>) manufactured brake linings (Prince et al., 2004). And while James Hardie is not alone in facing asbestos-related compensation claims in Australia, it faces significant liability due to the range of products manufactured and their dominance in the Australian market.

James Hardie had previously attempted reorganization and listing on the New York Stock Exchange (NYSE). However, this listing required the disclosure of asbestos liabilities in accordance with US generally accepted accounting principles (GAAP) for a US Securities and Exchange Commission (SEC) 20-F filing<sup>8</sup>. Importantly, Statement of Financial Accounting Standards No. 5 (FAS 5), *Accounting for Contingencies*, mandated the disclosure of undiscounted contingent liabilities for all companies in a group. The listing did not proceed reportedly due to a lack of interest in the initial public offering (Grant Samuel and Associates Pty Limited, 2001; Spender, 2003). While various reasons were mooted, James Hardie management decided that any further attempts at a listing in the US necessitated the deconsolidation of asbestos liabilities from the profitable operating businesses (JHIL, 2001a) (see Figure 1 below for a simplified representation of the corporate structure prior to Project Green).



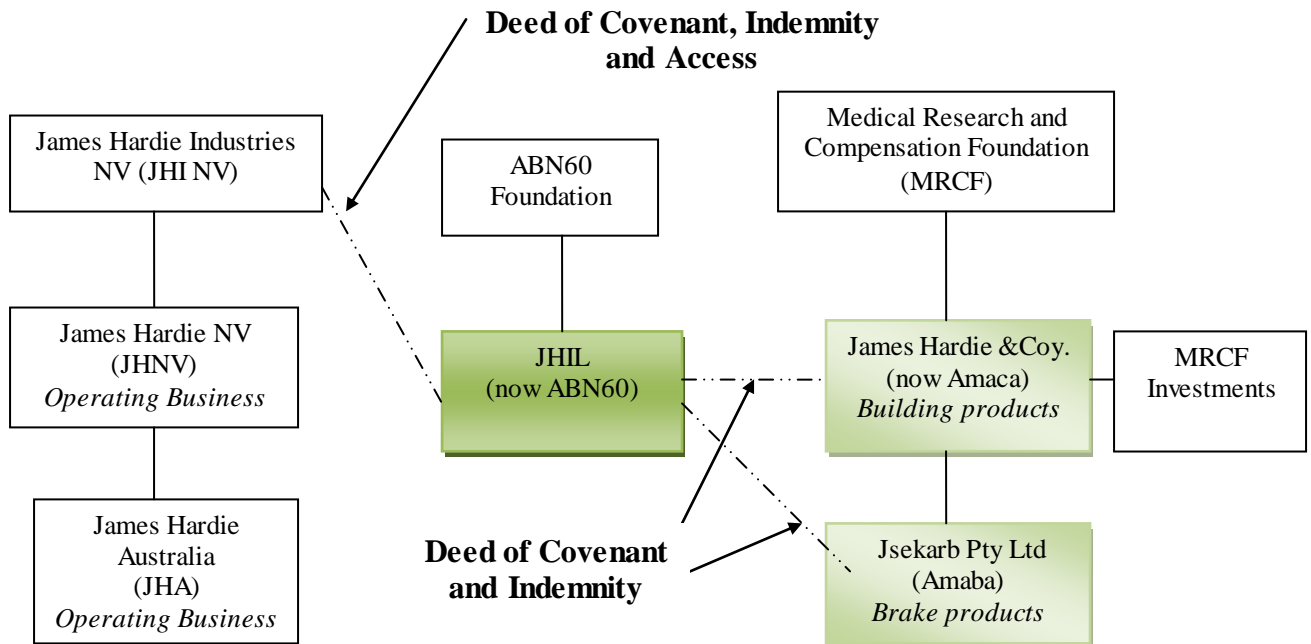
**Figure 1:** James Hardie group structure (excerpt) prior to Project Green reorganization strategy with former asbestos subsidiaries and parent highlighted (Adapted from: Jackson, 2004)

In February 2001, the two stages of Project Green commenced. The first, to isolate the former asbestos subsidiaries Coy and Jsekarb was completed by transferring these subsidiaries to the Medical Research and Compensation Foundation (MRCF), as a special purpose entity to fund both current and future asbestos-related claims.

However, despite jettisoning Coy and Jsekarb, a residual risk of asbestos-related litigation claims remained with the parent company, JHIL<sup>9</sup>. Additionally, by 2001 the US market for James Hardie building products was booming generating 80-90% of the group’s profits and, according to management, shareholder tax inefficiencies arising from profit repatriation to Australia was eroding shareholder value (JHIL, 2001a). To take advantage of the more favorable tax treatment afforded under the US–Netherlands Tax Treaty (Grant Samuel and Associates Pty Limited, 2001), the James Hardie parent company was transferred to the Netherlands following approval from both shareholders and the NSW Supreme Court. In a scrip-for-scrip swap<sup>10</sup>, the shareholders of JHIL became the shareholders of a newly created parent entity domiciled in the Netherlands, JHI NV, rendering JHIL a wholly owned subsidiary of this new parent company and further distancing current operations from the legacy of the former asbestos operations.

The new Dutch parent (JHI NV) purchased the current Australian non-asbestos operating subsidiaries from JHIL in exchange for callable partly-paid shares (\$1.96 billion outstanding) to meet any future asbestos claims against JHIL<sup>11</sup>. The partly-paid shares were subsequently cancelled in March 2003<sup>12</sup> and were substituted by a Deed of Covenant, Indemnity and Access<sup>13</sup>. This potential ‘life-line’ of funds for claimants against the former asbestos subsidiaries of the Group was now severed and the maneuvering achieved complete legal separation. Later that year, JHIL<sup>14</sup> was transferred to a new entity the ABN 60 Foundation (see Figure 2).

Figure 2 below demonstrates the key features of the outcome of reorganization of James Hardie. The former asbestos manufacturing and operating subsidiaries, Coy and Jsekarb, as well as the former parent company, JHIL, were completely isolated from future operating profits. By 2003, without other intervention, the only legal recourse for asbestos claimants was through the MRCF.



**Figure 2:** Reorganization of the former James Hardie Industries Ltd (JHIL) October 2003  
(Adapted from: Jackson, 2004). The companies highlighted represent the former parent company and asbestos subsidiaries.

The MRCF was created under the rules of incorporation as a ‘fully funded’ special purpose entity and legitimated by the “technical economic relation between assets and liabilities” (Delaney, 1989, p.663). However, skepticism and suspicion surrounded the financial adequacy of the MRCF to satisfy future claims (Spender, 2003) and, following considerable public outcry, a governmental Special Commission of Inquiry (Jackson Inquiry) was established to investigate the ability of the MRCF to manage its long-tail liabilities.

This paper focuses on the creation of the MRCF as integral to the success of the Project Green strategy. Delaney (1994, p.501) argues that “business bankruptcy provides a unique opportunity to assess how business executives and auditors arrive at the bottom line” as private company records generally not afforded to researchers become available. In addition, during legal proceedings, confidential documents are subpoenaed; experts are questioned about models and assumptions that formed opinions and calculations and the usually private space of the corporate boardroom is open to public gaze (Delaney, 1994). Similarly, the Jackson Inquiry made use of subpoenaed internal James Hardie documents including confidential material comprising minutes of board meetings; confidential board papers; email correspondence and documents containing legal advice; witness evidence from key actors such as the Chief Financial Officer, executive and non-executive board members; expert evidence from actuaries and legal advisors hired by James Hardie as well as outside experts not involved in the reorganization. This collated material became available on the publication of the Jackson Inquiry Report (Jackson, 2004) and provides the opportunity to interrogate deliberations that would normally remain private.

### 3. THE INTERDISCIPLINARY SPACE- STRATEGIC BANKRUPTCY

Delaney's approach to corporate reorganizations, in particular in bankruptcy regimes, is located between the disciplines of corporate law and accounting and this interstitial space presents opportunities for research (Hviding, 2003). Disciplinary knowledge is generally held to follow a dominant paradigm in which social and economic phenomena are studied. Since both corporate law and accounting are entrenched in an economic-based paradigm, a disruption of this assumption requires a consideration of the corporation as a conceptual artifact or social phenomenon (Dine, 2006) where the rules of incorporation prescribe the processes for its birth, life and death and accounting representations discursively create the corporate financial reality.

While more complex and contested than presented here, legal theories of the corporation are generally divided into two broad approaches: the concession theory, where the corporation is said to act as a collective and is endowed privileges by the State in return for public goods; and contract theory, which posits that the corporation is merely a nexus of contracts (Dine, 2006; Napier, 1998). The latter view is dominant and serves to limit the concepts of law and justice to a rationality understood through economic notions of market efficiency (Edelman, 2004). From this perspective, corporate law acts as a set of standardized rules to reduce contracting costs between various parties to promote market efficiency and influence individual (efficient) behavior (Delaney, 1994; Dine, 2006; Napier, 1998). This limited view of the corporation prioritizes market rationality and reinforces the notion that corporate form is 'dispassionate'. Corporate law acts to preserve distributive justice; for example, asset-allocation arrangements and creditor rights in times of corporate financial distress. Consequently, notions of compassion or rights to a moral claim are relegated to an arena of tort law (Spender, 2005, p. 280) where corrective justice is the objective. Therefore Delaney's critical sociological perspective allows alternate insights as it does not assume "that economic activity, whether market driven or manager driven, is fair, rational or socially beneficial" (Eckstein and Delaney, 1993, p. 305) but rather considers the social ramifications of corporate strategy.

Delaney (1989, 1992) initially examined the Manville Corporation; a US asbestos manufacturing company that employed the provisions available under Chapter XI<sup>15</sup> of the US Bankruptcy Code to allocate a specific and limited pool of funds to satisfy asbestos product liability claims despite being 'solvent' at the time. For companies exposed to asbestos litigation claims, the laws governing the conduct of corporations provide more certainty than other legal arenas. For example, in the US a special set of bankruptcy provisions, referred to as 'the Manville Provisions' (s524(g)), facilitate the reorganization of companies with substantial exposure to asbestos liabilities. Under these provisions, funding is negotiated and a trust established to provide compensation calculated to fund both present and future claims (White, 2002); however as:

bankruptcy has become routine for asbestos firms, their managers have become skilled either at transferring valuable assets out of the firm before it files for bankruptcy or at negotiating more favorable terms for the funding of compensation trusts (White, 2002, p. 7).

While Delaney's empirical material focused on corporate maneuvers in a US Chapter XI style bankruptcy regime this study extends the idea of strategic bankruptcy by exploring a socio-political context where the options available to management are different. In Australia, equity



insolvency and debtor-in-possession bankruptcies are not a part of the corporate landscape. Instead, the case presented here explores the establishment of a legally-separated business unit of limited potential as a parallel mapping of the premise of strategic bankruptcy to an alternate jurisdiction. In doing so, we highlight the ability of corporate management to exert their power and influence as a “middle-range action” where historical events and the institutional and political environment provide strategic options (Delaney 1989, p. 645). Table 1 demonstrates this parallel mapping of the targets of organizational strategy employed in a ‘strategic bankruptcy’ available under US Chapter XI style bankruptcy and the Australian legal regime.

**Table 1:** Parallel Mapping of Organisational Goals in ‘Strategic Bankruptcy (Adapted from Delaney 1994)

<b>Target of Organizational Strategy</b>	<b>Organizational Goal: Employ Chapter XI</b>	<b>Organizational Goal: Quarantine Asbestos Liabilities</b>
Defining Bankrupt Unit	Narrow definition/include weak units	Create special purpose entity (MRCF) and consume liability-laden subsidiaries.
Assets/Liabilities	Minimize Assets/Enhance Liabilities	Manage assets to exceed liabilities
Future Liabilities	Estimate and include on the balance sheet	Estimate and include on the balance sheet
Movement of Assets	Shift assets	Shift assets
Valuation Strategies	Unfavourable valuation strategies/methodologies	Strategic valuation strategies/methodologies
Stakeholder strategies	Communication to attenuate stakeholder ‘noise’	Communication to attenuate stakeholder ‘noise’

As with the cases studied by Delaney (1992), the organizational goal of reorganization to quarantine asbestos liabilities was shifted into the arena of corporate law. This arena provides both “a strategic opportunity to alter relationships in a corporate network drastically” and a “structured setting for mobilizing the legal process to transform troublesome ‘corporate life-threatening’ relationships into more stable controllable ones” (Delaney, 1989, p. 661) thereby shifting “future financial risk to other, more vulnerable parties” (Delaney, 1992, p. 162).

However, corporate reorganizations are enacted on a stage broader than the legal environment and,

[s]trategic actors cannot simply produce a discourse to suit their immediate needs and, instead, must locate their discursive activities within a meaningful context if they are to shape and construct action...If we want to explain how discourses operate, we must examine the broader

context in order to ascertain the scope it provides for action, as well as the limits it places on action (Hardy et al., 2000, p.1228).

The embedding of accounting discourse and meaning within the context of corporate law occurs in a socio-political environment that shapes the contours of actions available to management (Delaney, 1992) where

[a]ctors do not behave or decide as atoms outside a social context, nor do they adhere slavishly to a script written for them by a particular intersection of social categories that they happen to occupy. Their attempts at purposive action are instead embedded in concrete, ongoing systems of social relations (Granovetter, 1985, p. 487).

Strategic bankruptcy is concerned with the construction of the bottom line and how this is enacted or made possible through the use of 'intraorganizational' or internal resources and 'interorganizational' networks in the context of market or external exigencies (Delaney, 1994). Since organizations chart their own unique course through a sea of potential resources, networks and adversaries (Delaney, 1994), the following section foregrounds accounting as a key factor in shaping the contours of Project Green.

#### **4. THE CONTOURS OF CORPORATE STRATEGY**

The establishment of the MRCF provides an opportunity to study the micro-level construction of a bottom line (assets and liabilities). The analytical categories developed in Table 1 are extended to consider the relative power of various stakeholders and institutions (outlined in Table 2). This framework is used to explore corporate power such as knowledge, experience, legal, financial and public relations resources; and interorganizational power such as relationships with creditors, legal and accounting experts, as well as potential adversaries in the case of James Hardie.

**Table 2:** Factors shaping James Hardie strategy (Adapted from Delaney, 1994)

<b>Quarantine Asbestos Liabilities (from Table 1)</b>	<b>Intraorganizational Factors</b>	<b>Interorganizational (Network) Factors</b>
Create special purpose entity (MRCF) and consume liability-laden subsidiaries.	Shift organizational boundaries and the ‘corporate veil’	Corporations Law State and federal governments
Manage assets to exceed liabilities	Official Liabilities Valuable assets	Relationship with insurance companies, actuaries, legal and accounting experts
Estimate and include liabilities on the balance sheets	Professional judgment	Accounting Standards Accounting experts
Shift assets	Former subsidiaries	Accounting rules
Strategic valuation strategies/methodologies	Calculative practices Cash flow modeling	Relationship with actuaries and accounting experts
Communication to attenuate stakeholder ‘noise’	Rhetoric of shareholder value and communication media	Current and future claimants Relationship with trade unions State government

In addition to the vagaries of tax regimes and listing requirements in the US, Project Green was expected to provide a ‘comprehensive solution’ to a range of factors eroding ‘shareholder value’. These factors included: the increasing quantum of claims; the failure of the insurance company to contribute fully to the satisfaction of claims; and, the impending changes to domestic accounting rules. While James Hardie was able to draw on considerable intraorganizational resources they were reliant on external institutions and mindful of the potential for stakeholder noise to disrupt Project Green. The following analysis focuses on James Hardie’s ability to shift organizational boundaries and control the accounting representations of assets and liabilities within the context of the interorganizational networks and potential adversaries.

### *Create a Special Purpose Entity*

The defining boundaries of the separate legal entity are enshrined in corporate law, however what constitutes a corporate entity is often disputable and able to be manipulated to pursue important or multinational organizational goals. Delaney (1994, p.505) argues that “whomever has the power to determine what social grouping is defined as the “bankrupt unit” exercises significant control over the bottom line”. Assets and liabilities, representing future economic benefits and sacrifices communicate ‘net wealth’ and accounting information facilitates and legitimates corporate reorganization strategies by ascribing economic value to objects, artifacts and economic transactions, presented as “objective and unproblematic without consideration of the nuances and subjectivities of the [accounting] rules” (Moerman and van der Laan, 2007, p. 364).

Since these rules are made within the socio-political context of standard setting, the elements of financial reports are, therefore, socially constructed and legally sanctioned (Morgan, 1988) and corporations have the opportunity to ‘tell their story’ and operationalize strategy through an ability to define both the legal and financial boundaries of responsibility.

While corporate law provides the skeleton, codifying the rights and obligations of the entity and defining the boundary of legal responsibility, it is accounting representations and the meanings embedded in terms such as asset and liability in specific contexts that breathe economic life into an entity and legitimate ‘rational’ strategic action. The MRCF initially presented a ‘technically solvent’<sup>16</sup> balance sheet conveying a limited, but adequate, ability to satisfy current and future asbestos claims. However, by 2003, with the cancellation of the partly-paid shares and changes to the accounting standards for the recognition and measurement of long-tail liabilities, the inadequacies of funding and the tenuous solvency status of the MRCF became obvious (Jackson, 2004).

### *Manage Assets*

Quantifiable constructs of both *valuable assets* and *official liabilities* played a pivotal role in the creation of the MRCF’s balance sheet. The media release announcing the establishment of the MRCF, directs stakeholders to a pool of “substantial assets for the benefit of claimants” (JHIL, 2001b), and

[t]he \$293 million assets of the [MRCF] include a portfolio of long-term securities, a substantial cash reserve, properties which earn rent and insurance policies which cover various types of claims, including all workers compensation claims.

On closer scrutiny, two of these valuable assets were derived from the recognition of certain accruals. First, to effect the repositioning of Coy and Jsekarb to the MRCF, Deeds of Covenant of Indemnity (Deeds) were negotiated between the parent and the former subsidiaries for a consideration of \$234.15 million (undiscounted over a period from 2001 to 2042). These Deeds reinforced legal separation and performed important accounting functions. Since these Deeds could only be executed in exchange for valuable consideration, the amount settled on the former subsidiaries was recognized as an asset on the MRCF’s balance sheet. The Deeds also indemnified the parent company, James Hardie Industries Limited (JHIL) not for only asbestos liabilities, but for “questionable” inter-company transactions such as dividends, management fees and distributions (Jackson, 2004, p. 331) that occurred in the lead up to separation.

Second, James Hardie’s long-standing product and public liability insurer, QBE Insurance (QBE) negotiated a settlement in 2000. Previously, in 1977 QBE had cancelled its policies with James Hardie, citing failure to disclose information regarding the risks of asbestos exposure. A protracted court battle ensued and after several attempts to resolve the issue an amount of \$47 million payable in 14 annual instalments to the subsidiary, Coy (Jackson, 2004). Therefore, the assets of Coy and Jsekarb available to the MRCF largely comprised receivables due from other James Hardie entities including amounts arising from: real estate leases; loans; any future amount receivable under the Deed of Covenant and Indemnity with the former parent; and, future instalments from the settlement with their former insurer, QBE. While these assets totaled \$293 million, the amount of cash and cash equivalents available to fund asbestos claims was a mere \$47.9 million (Jackson, 2004).

### *Estimate Liabilities*

Accounting disclosures are often used to legitimate something that is “valued and vague” or where there is a “need to convey some value to a third party” (Delaney, 1994, p.512). In the process of legitimating the ‘valued and vague’, expertise in the form of ‘judgments’ from a range of professionals is co-opted. The notion of judgment is entrenched in institutional and corporate discourse and informs professional experts. The role of accounting experts is highlighted in the valuation and disclosure of asbestos liabilities.

Prior to Project Green, Australian companies were only required to disclose *known* litigation claims. However changes to the measurement and disclosure of long-tail liabilities were mooted in exposure draft ED 88 *Provisions and Contingencies* that was released in late 1998 for public comment (Thomson, 2001). ED88 outlined a proposal for the recognition of a provision for those liabilities that were ‘probable’ and could be measured ‘reliably’. The subsequent standard, AASB 1044 *Provisions, Contingent Liabilities and Contingent Assets* (issued in October 2001), provided the scope to bring long-tail liabilities onto the balance sheet. The impending promulgation of AASB 1044 was an exigent issue in the timing of the establishment of the MRCF. The CEO highlighted the urgency of proceeding with Project Green.

Delaying creation of a Foundation past financial year end significantly increases the risk of ED 88 complications. Latest intelligence is that ED 88 will be promulgated before the end of this financial year (Peter Macdonald, CEO, in JHIL, 2001a, p. 4).

As the CEO (JHIL, 2001a, p. 4) further argued “James Hardie needs to act now” to prevent the negative effect of the new accounting standard on the financial statements of the Group. The altered recognition criteria stipulated that an accredited actuarial estimate of the present value of the ‘best estimate’ would suffice as a reliable measure. And, only in cases where future liabilities could not be reliably measured did they remain off-balance sheet as a contingent liability or moral obligation. James Hardie managed this process by determining ‘official’ liabilities and coordinating the timing of disclosure through the strategic use of expert valuations.

For several years, James Hardie had employed the actuarial firm Trowbridge Consulting to provide in-house estimates of future asbestos liabilities<sup>17</sup> for claims management purposes. This engagement included “managing Trowbridge” so they knew “which parts of the report may be made public” (Jackson, 2004, exhibit 61). Management maintained that these in-house estimates did not satisfy the accounting recognition requirements for a liability and, accordingly, James Hardie disclosed a contingent liability of \$43 million for *known* or current asbestos-related claims in the annual report (JHIL, 2000). The following year, these in-house estimates transmogrified into a reliable estimate of Net Present Value<sup>18</sup> (NPV) \$286 million as the ‘most likely’ or ‘best estimate’ of both current and future claims (JHIL, 2001b). The previously valued but vague liability became an official long-tail liability that could be transferred to the MRCF through the strategic use of actuarial estimates.

### *Shift Assets*

The use of accounting transactions to transfer or shift assets and liabilities within a corporate group is a common practice and the notion of ‘lifting the corporate veil’ has been a topic of vigorous debate in Australia, particularly in cases involving corporate group liabilities and

insolvent subsidiaries (Austin, 1998; Clarke and Dean, 2007; Dean and Clarke, 2005; Hill, 1995; Murphy, 1998; Parker, 2006; Wyatt and Mason, 1998).

From the early 1990s a number of options to separate asbestos liabilities from operational activities had been canvassed by James Hardie management and in anticipation of a future corporate reorganization, the core technologies of Coy and Jsekarb had already been transferred to other companies within the corporate group. Further asset transfers occurred with the sale of plant and equipment to other subsidiaries (Jackson, 2004). These former asbestos liability laden subsidiaries that plagued the James Hardie group balance sheet were shifted to the new entity, the MRCF, and recognized as 'assets'.

### *Strategic Valuations*

Valuations, despite an air of objectivity, are subjective and ambiguous and these attributes are compounded in cases, such as James Hardie, where estimated long-term assets and liabilities are relied upon (Delaney 1989). Therefore, the power of the company to control the process of calculating and legitimating valuations and the reliance on expert advice is crucial (Delaney, 1994).

As with the estimates of the official liabilities, the asset values were legitimated by the advice and recommendations of experts, providing the economic rationale for the MRCF's ability to 'fund' claims.

In establishing the [MRCF], James Hardie sought expert advice from a number of firms, including PricewaterhouseCoopers, Access Economics and the actuarial firm, Trowbridge. With this advice, supplementing the company's long experience in the area of asbestos, the directors of JHIL determined the level of funding required by the [MRCF] (JHIL, 2001b).

The objectification of uncertainty and the recognition of the long-tail liability as 'official' in a single figure obfuscates the assumptions and uncertainties inherent in valuation techniques and models. Compounding this issue for the MRCF was the mismatch in the calculative practices. The actuarial estimation of liabilities used discount rates of 7% p.a. over 20 years. Subsequently, this actuarial estimate<sup>19</sup> proved to be problematic (Gunz and van der Laan, 2011) for several reasons including the omission of recent claims data (approximately 8 months) and the truncated (20 year) projection for future claims. The additional data and forward projections over a longer period were later found to yield much higher estimates (Jackson, 2004, p. 27) rendering the MRCF technically insolvent from inception. This official liabilities figure was 'balanced' against the investments held as non-current assets using a constant earnings rate of 11.7% p.a. over 50 years<sup>20</sup>. The Jackson Inquiry found that the earnings rate was 'selected simply to achieve the result that the model showed significant surpluses of funds over its life' (Jackson, 2004, p. 9). Management, announcing the establishment of the MRCF and its 'fully funded' status, confidently boasted that the assets of the Foundation (\$293 million) exceeded its current and future liabilities (\$286 million) (JHIL, 2001b). James Hardie was able to draw on substantial intraorganizational resources including legal support, financial expert advice and media to confirm a fully funded and viable entity to legitimate this crucial stage of the reorganization strategy. The power to determine the timing of both the asset transfers and the disclosure of a vague contingency for asbestos liabilities as an official liability "recognized by key economic and political institutions" (Delaney, 1994, p.504) was reinforced by interorganizational relationships

and networks with valuation and accounting experts and managed through communication strategies.

### *Communication and Stakeholder Noise*

Delaney (1989, 1994) considers that the strength of adversaries constrains corporate action. James Hardie had anticipated obstacles to the reorganization strategy in general and to the creation of the MRCF in particular;

A significantly worse than expected reaction to the creation of the Foundation [MRCF] may require us to re-think the timing and some details of the remainder of the program...even in the face of significant ‘noise’ about separation (Macdonald, CEO, James Hardie Industries Limited, 15<sup>th</sup> February, 2001a).

James Hardie management documented and rated the legal, political and reputational risk of select adversaries that could negatively impact their strategic course which included trade unions and the government.

The Australian industrial landscape has featured strong protection of workers’ rights through the trade union movement and James Hardie management assessed the risk of a ‘vocal and negative response’ to the creation of the MRCF by trade unions as ‘medium’ (JHIL, 2001a, p. 21). In particular, trade unions have championed the ‘cause’ to protect the rights of workers and their entitlements in some high profile cases of corporate, or pending corporate, insolvency (Floyd, 2005). However, with a less than 1% union shareholding via superannuation (pension) funds<sup>21</sup> the risk of any actual shareholder intervention in James Hardie’s affairs was not regarded as significant (JHIL, 2001a). Therefore, any threat of trade union instigated ‘noise’ was considered of little consequence.

The historical development of the relationship between State<sup>22</sup> and Commonwealth jurisdictions led James Hardie management to perceive the risk of government intervention to the creation of the MRCF as “low on legal and commercial grounds”, however not to be “ruled out on political grounds” (JHIL, 2001a, p.16).

The easiest practical option for the NSW Government would be to ‘flick-pass<sup>[23]</sup>’ the issue to the Federal Government and ask that they deal with it as an issue of Corporations Law (JHIL, 2001a, p. 19).

The possible stakeholder ‘noise’ contributed to the speed and stealth by which the reorganization was effected. The ‘private and confidential’ Project Green was tabled and approved by the Board on the evening of February 15<sup>th</sup> 2001. The following morning, a media release, coinciding with the quarterly results, announced to the public the creation of the MRCF as providing ‘certainty for people with a legitimate claim against the former James Hardie companies which manufactured asbestos’ and which has ‘sufficient funds to meet all legitimate compensation claims anticipated’ (JHIL, 2001b). As history has demonstrated the MRCF had no prospect of meeting the liabilities (Jackson, 2004) of the largest, yet least powerful group of creditors, the current and future claimants. Despite assessing the risk of stakeholder noise as low, the combination of the government, trade unions and victim support groups became a powerful coalition of adversaries when the financial adequacy of the MRCF was publically questioned.

The nature of asbestos-related disease and the consequent long-tail liability resulted in the largest creditor transitioning from balance sheet opacity to transparency through changes to accounting techniques (Moerman and van der Laan, 2013b), only to be cast adrift. While seemingly counterintuitive to ‘officially’ recognize James Hardie’s contingent asbestos liabilities, management understood the necessity to manage this complex issue through accounting measurement. In the aftermath of the Jackson Inquiry, the MRCF has been replaced by a new arrangement between James Hardie, the government and trade unions (representing asbestos victim support groups). In doing so, it has produced an outcome that mirrors arrangements in the US where corporate bankruptcy is a viable strategic option to manage corporate ‘life-threatening’ relationships.

## 5. CONCLUSION

Project Green, was operationalized at a time that presented strategic opportunities in the context of external constraints. The stated ultimate objective of Project Green was to improve shareholder value and position “James Hardie for future growth” (JHIL, 2001a, p. 1). In order to achieve these ends, the former parent company sought certainty and refuge by positioning the asbestos issue in an arena where the language of accounting plays a pivotal role in both negotiating meaning and mediating the boundaries of the economic unit and constructing the ‘bottom line’. The lens of strategic bankruptcy illuminates both the *ex ante* context and the *ex post* legitimization of strategic decision-making in an environment of scarce resources. This paper has provided an example at the interstitial space where law and accounting provide opportunities to further corporate strategy. Companies, such as James Hardie, are able to draw on significant intraorganisational resources to exploit these opportunities. However, strategy is not conducted in an organizational vacuum and strategic bankruptcy offers a critical sociological framework to consider the relative power of interorganizational networks and adversaries that shape its contours.

As Delaney (1989, 1992) aptly demonstrates, corporate attempts to avoid financial responsibility for their activities are not new, especially in the case of a long-tail tort liability. The elimination of asbestos legacies by quarantining claims from operating entities raises “important questions about continued community acceptance of a legal doctrine which suspends the natural consequences of tort law in favour of companies and their shareholders to the detriment of involuntary tort creditors” (Dunn, 2005, p. 340). In an effort to sever “troublesome ties” and to avoid future financial burdens, corporate reorganizations have the potential to transfer financial risks to more vulnerable parties (Delaney, 1992, p. 179). Asbestos claimants entitled to corrective justice through tort litigation were potentially limited to receive only distributive justice from a business unit with limited ability to satisfy current and future claims.

Accounting information has hegemonic potential through “the power relations associated with the allocation and control of scarce resources” (Morgan, 1988, p. 482) and the ‘implications for what is permissible’ (Burr, 2003, p. 5). This power is particularly salient in an environment where are used to “generate new meanings that help – or hinder – the enactment of particular strategies” (Hardy et al., 2000, p.1228). In a global environment where there is a drive to standardize or harmonize accounting, cases such as James Hardie highlight the vexed issue of sovereignty and national legal regimes that regulate corporate activities. The creation of the MRCF was a tailored strategic action that mobilized official liabilities in a particular legal arena



to achieve the same goal as other notable cases such as Manville, where claims to a strategically created 'bottom line' are invoked to manage financial risks.

## Postscript

The Commission of Inquiry into the establishment of the MRCF (the Jackson Inquiry) found that the *Corporations Act 2001 (Cth)* was unable to assist the MRCF to manage its liabilities. However, on 14 July 2004 the board of James Hardie announced it would recommend to shareholders the approval for additional funding for the MRCF (Jackson, 2004). Subsequently, a funding agreement was negotiated in 2006 where a proportion of free cash flow (under certain circumstances) would be made available to claimants (through a new body, the Asbestos Industries Compensation Fund (AICF)) (for more information see: [www.ir.jameshardie.com.au](http://www.ir.jameshardie.com.au)).

Additionally, in August 2009 JHI NV shareholders voted in favour of a resolution to re-domicile the company again (to Ireland) in a new form of corporate vehicle (Societas Europea) to improve its tax position which was not achieved through domiciling in the Netherlands. The company argued the move would not affect its commitment to contribute to the AICF, however it would likely reduce its ability to contribute in 2011 (AAP, 2009: JHI NV, 2009).

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<sup>1</sup> Asbestosis was listed as the cause of death for workers in the industry as early as 1931 (Tweedale, 2000). A landmark study in 1964 demonstrated the link between exposure to asbestos and several types of lung cancer (Selikoff in Delaney, 1992)

<sup>2</sup> Exposure to asbestos poses health risks ranging from asymptomatic calcified scarring of the lungs, through to functionally limiting conditions such as asbestosis, lung cancer and the fatal cancer of the pleural or peritoneal cavity, mesothelioma.

<sup>3</sup> A tort is a breach of duty of care caused by an act or failure to act which causes harm for which the remedy is damages. A long-tail tort means that there is a long latency period between a person's use or exposure to a harmful product and the first manifestation of harm (Spender, 2003).

<sup>4</sup> Asbestosis and mesothelioma are almost exclusively linked to asbestos exposure.

<sup>5</sup> The most populous state in Australia. Australia has the highest per capita incidence of asbestos-related disease in the industrialized world (Peacock 2009; Safe Work Australia, 2009)

<sup>6</sup> Renamed Amaca on 23rd February 2001.

<sup>7</sup> Renamed Amaba on 20th February 2001.

<sup>8</sup> A 20-F filing is the initial registration of foreign securities.

<sup>9</sup> In Australia the courts have been reluctant to 'lift the corporate veil' (Austin, 1998) and find a parent company liable for the actions of a subsidiary, however significant uncertainty remains whether this will always be the case.

<sup>10</sup> The Scheme of Arrangement allows for the shareholders to 'sell' their shares in JHIL without triggering a capital gains tax event.

See for example:

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[http://www.ir.jameshardie.com.au/jh/shareholder\\_services/dutch\\_withholding\\_tax/australian\\_tax\\_implications\\_of\\_2001\\_restructure.jsp](http://www.ir.jameshardie.com.au/jh/shareholder_services/dutch_withholding_tax/australian_tax_implications_of_2001_restructure.jsp)

<sup>11</sup> James Hardie needed to secure NSW Supreme Court<sup>11</sup> approval for a Scheme of Arrangement to re-domicile in the Netherlands. The Scheme of Arrangement was premised on certain agreements to satisfy the Court that the interests of stakeholders, including current and future asbestos claimants, would not be compromised. The arrangement was meant to ensure that the former parent, JHIL had the ability to satisfy any future asbestos-related liabilities through future calls on partly-paid<sup>11</sup> ordinary shares. Despite assurances given to the Court by management, this was merely a transitional device to ensure 'stakeholder management' rather than a life-line for asbestos victims (Haigh, 2006, p. 282) as evidenced by the subsequent cancellation of the shares casting claimants adrift.

<sup>12</sup> Legal advice was sought by JHI NV and there was much conjecture as to the legality of the cancellation of the shares which effectively reduced JHIL's share capital. *The Corporations Act 2001* (Cth) provides that reductions in share capital are possible provided, amongst other things, the reduction 'does not materially prejudice the company's ability to pay its creditors'(s.256B(1)A). The critical issue was whether future asbestos litigants met the criteria to be considered creditors (Jackson, 2004).

<sup>13</sup> The Deed of Covenant, Indemnity and Access was between JHI NV and JHIL (now ABN60) and covenanted that asbestos claims were not to be made against any JHI NV Party (any part of the group – but not the former asbestos subsidiaries) and indemnified each JHI NV Party against losses arising from asbestos claims (see Jackson, 2004, esp. Chapter 28).

<sup>14</sup> Renamed ABN 60 on 8<sup>th</sup> April 2003.

<sup>15</sup> U.S. Chapter XI bankruptcy allows an out-of-court workout for firms in financial distress to restructure their debt and continue their operations (Chatterjee et al., 1996).

<sup>16</sup> Here we use the term 'technically' solvent to mean reported on-balance sheet assets exceed on-balance sheet liabilities.

<sup>17</sup> In 1996 the estimate was \$230 million (Jackson, 2004, p. 589)

<sup>18</sup> Based on discount rate of 7% and a time period of 20 years, net of insurance recovery.

<sup>19</sup> Two of the incoming directors were former directors of entities in the James Hardie Group.

<sup>20</sup> The valuation of investments was known as the 'Twelfth Cash Flow Model' by JHIL (Jackson, 2004)

<sup>21</sup> Superannuation fund is the term given to pension funds in Australia.

<sup>22</sup> The asbestos subsidiaries, Coy and Jsekarb, were incorporated in NSW and to address the large number of claims arising from pneumoconiosis in NSW, the State Government formed the Silicosis Board as a workers' compensation body in 1927, which later became the Dust Diseases Board (DDB) in 1942. With claims spiralling in NSW, to address non-occupational dust diseases and to relieve the increasing load on the NSW court system, the Dust Diseases Tribunal (DDT) was established in 1989 to expedite the processing of tort claims (DDT, 2007).

<sup>23</sup> A 'flick pass' is a sporting term mainly used in games such as Rugby Union and Rugby League. It means a short sharp pass (usually behind the back) to a member of your own team resulting in a change of direction in the play or point of attack.